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No. 02-1196

In the Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES E. EDWARDS

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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13 pp

TABLE OF AUTHORITIES

Cases:	Page
Abbett, Sommer & Co., In re, 44 S.E.C. 104 (1969), order aff'd, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) 92,813 (D.C. Cir. Sept. 25, 1970)	9
Aron v. *United States*, 291 F.3d 708 (11th Cir. 2002)	7
Barnhart v. *Walton*, 122 S. Ct. 1265 (2002)	7
Chevron U.S.A. Inc. v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984)	9
Graham v. *SEC*, 222 F.3d 994 (D.C. Cir. 2000)	10
Marine Bank v. *Weaver*, 455 U.S. 551 (1982)	3
Reves v. *Ernst & Young*, 494 U.S. 56 (1990)	2, 5
Richmond Screw Anchor Co. v. *United States*, 275 U.S. 331 (1928)	7
SEC v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943)	3, 5
SEC v. *Energy Group of Am., Inc.*, 459 F. Supp. 1234 (S.D.N.Y. 1978)	9
SEC v. *Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), cert. denied, 532 U.S. 905 (2001)	7, 8
SEC v. *W.J. Howey Co.*, 328 U.S. 293 (1946)	2, 3, 4
SEC v. *Zanello*, C.A. No. 02-CV-3308 (N.D. Ga. Dec. 10, 2002)	10
SEC v. *Zandford*, 535 U.S. 813 (2002)	2
Steel Co. v. *Citizens for Better Env't*, 523 U.S. 83 (1998)	2
Turicentro, S.A. v. *American Airlines Inc.*, 303 F.3d 293 (3d Cir. 2002)	2
Union Home Loans, In re, 26 S.E.C. Dkt. 1517 (Dec. 16, 1982)	9
United Housing Found., Inc. v. *Forman*, 421 U.S. 837 (1975)	3, 4
United States v. *Carman*, 577 F.2d 556 (9th Cir. 1978)	7

Cases—Continued: Page

United States v. *Mead Corp.*, 533 U.S. 218 (2001) 9
United States v. *Mendoza*, 464 U.S. 154 (1984) 9
Utah Power & Light Co. v. *United States*, 243 U.S. 389 (1917) 9-10
Wals v. *Fox Hills Dev. Corp.*, 24 F.3d 1016 (7th Cir. 1994) 3

Statute:

Securities Exchange Act of 1934 § 15(b)(4), 15 U.S.C. 78o(b)(4) 9

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The court of appeals dismissed the complaint of the Securities and Exchange Commission (SEC) based on the erroneous conclusion that an investment is not an "investment contract" if the promoter promises a fixed return or the investor is contractually entitled to a particular amount or rate of return. Those restrictions are unsupported by the text, background, and purposes of the securities laws, and they depart from the flexible understanding of "investment contract" consistently applied by this Court. The court of appeals' decision conflicts with decisions of other courts of appeals and the SEC's longstanding interpretation of the securities laws. The decision also opens a seemingly limitless gap in the protection those laws provide against fraud, because it allows unscrupulous promoters to circumvent the laws by describing the returns offered by investment schemes as fixed or contractually guaranteed amounts. This Court's review is therefore warranted.[1]

[1] Contrary to respondent's contention (Br. in Opp. 4 n.2), the Court must accept the truth of the allegations in the SEC's complaint. The court of appeals not only reversed the preliminary injunction, but also ordered

1. a. Respondent does not dispute that the plain meaning of "investment contract" encompasses arrangements promising fixed returns and returns specified as entitlements in a contract. See Pet. 10-11. Instead, he contends that the SEC is "mak[ing] a fortress out of the dictionary," and that a statute's plain meaning does not preclude consideration of "persuasive evidence" to the contrary "if it exists." Br. in Opp. 13 (citations omitted). But the SEC is simply starting statutory interpretation where it must—with the language of the statute. And respondent offers no "persuasive evidence" that the statute means anything other than what it says.

In particular, respondent can find no support in the background and purposes of the securities laws. As this Court explained in *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 298 (1946), when Congress enacted those laws, the term "investment contract" had a well-established meaning under state Blue Sky laws, and Congress adopted that meaning. The petition explains, and respondent does not dispute, that the established meaning of "investment contract" included an investment with a fixed or guaranteed return. See Pet. 11-12. That meaning comports with the purpose of the securities laws "to regulate *investments*, in whatever form they are made and by whatever name they are called." *Reves* v. *Ernst & Young*, 494 U.S. 56, 61 (1990). To achieve that goal, Congress included in the definition of security certain "general descriptive designations," such as "investment contract," to ensure coverage of "[n]ovel, uncommon, or irregular devices." *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943). The term "investment contract" thus promotes Congress's goal of comprehensive coverage by serving as a catch-all for "unconventional instruments that have the essential properties of a debt or equity security." *Wals* v. *Fox Hills Dev. Corp.*, 24 F.3d 1016, 1018 (7th Cir. 1994).

Respondent does not explain why Congress would have excluded unconventional investments with fixed or contractually guaranteed returns from the coverage of the securities laws. Instead, he argues (Br. in Opp. 10-11) that the term "investment contract" is not intended to be a catch-all. But that assertion is belied by *Joiner*'s description of the term's role. Respondent also is incorrect in contending (*id.* at 11 n.7) that the only catch-all in the definition of security is the term "any interest or instrument commonly known as a 'security.'" That term is intended to catch some items not specifically enumerated, but it encompasses only arrangements "commonly known as a 'security.'" "Investment contract," in contrast, catches arrangements that, although they may not be "commonly known" at all, "embod[y] the essential attributes" of "a security." *United Housing Found., Inc.* v. *Forman*, 421 U.S. 837, 852 (1975).[2]

b. Respondent mistakenly asserts (Br. in Opp. 6-9) that limiting investment contracts to variable return investments is required by this Court's cases. He notes (*id.* at 7-8) that the Court observed in *Howey* that the investors "share[d] in the earnings and profits" of the enterprise. 328 U.S. at 300. But the Court made that observation to demonstrate that in-

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dismissal of the complaint. The court labeled the dismissal as based on lack of subject matter jurisdiction. In reviewing a dismissal on that ground, this Court must accept the allegations as true because the court of appeals held the complaint facially insufficient, not factually unsupported. See *Turicentro, S.A.* v. *American Airlines Inc.*, 303 F.3d 293, 300 n.4 (3d Cir. 2002). If the dismissal is instead viewed as based on failure to state a claim, see *Steel Co.* v. *Citizens for a Better Env't*, 523 U.S. 83, 89 (1998) ("absence of a valid (as opposed to arguable) cause of action does not implicate subject-matter jurisdiction"), the allegations must likewise be regarded as true. See *SEC* v. *Zandford*, 535 U.S. 813, 818 (2002).

[2] Citing *Marine Bank* v. *Weaver*, 455 U.S. 551 (1982), respondent suggests (Br. in Opp. 6 n.3) that it is unnecessary to include the ETS investments within the scope of the securities laws because they are covered by Federal Trade Commission (FTC) disclosure rules. But, unlike the bank regulations and federal deposit insurance that this Court relied on in *Marine Bank* in holding that ordinary, federally-insured bank certificates of deposit are not securities, FTC disclosure rules do not reduce risk to investors by assuring ETS's ability to pay them.

vestors were "attracted solely by the prospects of a *return* on their investment." *Ibid.* (emphasis added). The Court did not suggest that it mattered whether the return was fixed or variable. Indeed, the Court made clear that an "investment contract," as reflected in the state Blue Sky law cases, includes any "contract or scheme for 'the placing of capital or laying out of money in a way intended to secure *income or profit* from its employment.'" *Id.* at 298 (citation omitted) (emphasis added)). Neither "income" nor "profit" is limited to a variable return. Pet. 11. Although, in paraphrasing that established definition, the Court stated that an investment contract involves the expectation of "profits," 328 U.S. at 299, nothing suggests that the Court intended to exclude fixed returns. On the contrary, the Court cited with approval several cases involving fixed returns. See Pet. 12, 16.

Respondent incorrectly contends (Br. in Opp. 8-9) that the Court subsequently excluded fixed-return instruments by statements in *Forman* and *Reves*. Describing its prior cases, the Court in *Forman* stated that, "[b]y profits, the Court has meant either capital appreciation * * * or a participation in earnings." 421 U.S. at 852. But that statement did not substitute a new definition of "investment contract" for the one adopted in *Howey* or limit investment contracts to arrangements providing variable returns. The Court's point was simply to distinguish the situation in which an investor is "'attracted solely by the prospects of a return' on his investment," which involves a security, from a situation in which "a purchaser is motivated by a desire to use or consume the item purchased," which does not involve a security. *Id.* at 852-853. Moreover, the Court made clear that "profit may be derived from the *income* yielded by an investment," *id.* at 855 (emphasis added), and that the essence of the test is whether "the investor is 'attracted solely by the prospects of a *return*' on his investment," *id.* at 852 (emphasis added). "Income" and "return" are not limited to variable yields. Pet. 18. Nor is "a participation in earnings" limited to an investment with a return *measured* by earnings. An investor

expects a participation in earnings whenever he expects that the *source* of his return will be the company's earnings.

Respondent observes (Br. in Opp. 8-9) that, in a footnote in *Reves*, the Court read *Forman* to limit "profits" to a return "keyed to the earnings of the enterprise." 494 U.S. at 68 n.4. But, as the petition explains, the issue in *Reves* was the scope of the term "note," not "investment contract," and the Court accordingly stated that "the *Howey* test is irrelevant to the issue before us today." Pet. 19 n.6 (quoting *Reves*, 494 U.S. at 68 n.4). Because the *Howey* test was not before the Court in *Reves*, the Court had no occasion (and did not purport) to alter that test. The Court merely characterized how it believed *Forman* had interpreted the test, and that characterization was mistaken.

Respondent also cannot reconcile (Br. in Opp. 14-15) his position with *Joiner*'s teaching that, in determining whether an offering is an investment contract, "it is not inappropriate that promoters' offerings be judged as being what they were represented to be." 320 U.S. at 353. As the petition explains (at 17), and the district court found, ETS's marketing materials stressed "the 'profitability' of payphones and encouraged investors to 'watch the profits add up,'" and "ETS websites noted the 'profitable' opportunities for investors." Pet. App. 18a. After luring investors with promises of "profits," respondent cannot, consistent with *Joiner*, contend that his scheme did not involve an expectation of profits that rendered the resulting arrangements investment contracts.[3]

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[3] Although respondent asserts (Br. in Opp. 14) that the SEC inaccurately describes the marketing materials, the SEC's description mirrors the district court's findings and is supported by the record. Respondent admitted (10/12/00 Tr. 59) that he designed Exhibit 17, which contains several statements aimed at potential purchasers of payphones that tout the profitability of the phones. See Exh. 17, at 4, 7, 10. Although respondent claims that Exhibit 17 was not given to prospective investors, he admitted (10/12/00 Tr. 59) that distributors used a document "similar" to Exhibit 17 to sell the phones. Documents provided to prospective investors, as well as publicly available websites, contained statements virtually identical to those in Exhibit 17. See Exh. 15, at 8-9; Exh. 22, at 1,

c. Respondent also incorrectly argues that the court of appeals' decision did not "turn on whether the payments [investors received] were fixed or variable," Br. in Opp. 12. The court's opinion speaks for itself: The court first stated that, under *Forman*, an investment contract must involve "either a participation in earnings by the investor or capital appreciation." Pet. App. 6a. The court then stated that "capital appreciation is not at issue," and "the fixed lease payments paid to owners of the telephones cannot be considered participation in earnings." *Id.* at 6a-7a. The court explained that, "[b]ecause the investors received a fixed monthly sum, the actual earnings of their telephone, or ETS, were irrelevant." *Id.* at 7a. The "fixed" nature of the return was thus plainly the linchpin of the court's decision. That is unsurprising because that is what respondent argued to the court of appeals. See Br. of Appellant 27-29.

Respondent suggests that the court of appeals distinguished between a fixed payment and "a fixed payment not derived from capital appreciation or a participation in earnings." Br. in Opp. 12. But respondent does not explain that purported distinction, show where the court of appeals made it, or explain why ETS investors did not expect that their lease payments would be derived from ETS's earnings on the telephones. Investors would have had that expectation because the marketing materials and other communications stressed the profitability of both payphones in general and ETS in particular. See Pet. 3, 4.

d. Rather than defend the court of appeals' alternative holding that the payphone interests were not investment contracts because "the investors were entitled to their lease payments under their contracts with ETS" (Pet. App. 8a), respondent dismisses (Br. in Opp. 15-16) that holding as

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5, 6; Exh. 24, at 1. Likewise, a document that respondent admits (Br. in Opp. 14 n.8) was the marketing material for the lease program also refers to "profits" for owners of payphones. See Exh. 18, at 3. Respondent is correct, however, that the petition mistakenly cites to Exhibit 14, which is not part of the record. See Br. in Opp. 14 n.8.

dicta. Alternative holdings are, however, binding precedent, including in the Eleventh Circuit. See *Richmond Screw Anchor Co.* v. *United States*, 275 U.S. 331, 340 (1928); *Aron* v. *United States*, 291 F.3d 708, 713 n.4 (11th Cir. 2002). And they are subject to review and reversal by this Court. See, *e.g.*, *Barnhart* v. *Walton*, 122 S. Ct. 1265, 1268-1269 (2002) (reversing two alternative holdings construing the Social Security Act).

2. Respondent also errs in contending (Br. in Opp. 16-20) that the decision below does not conflict with decisions of other courts of appeals. He does not even mention the cases from the First, Second, Sixth, Seventh and D.C. Circuits cited in the petition (at 22-23) in which the courts found schemes yielding fixed or contractually guaranteed returns to be investment contracts. Furthermore, he fails to reconcile the cases he does discuss with the decision here.

For example, respondent asserts (Br. in Opp. 17-18) that there is no conflict with *United States* v. *Carman*, 577 F.2d 556 (9th Cir. 1978), because *Carman*'s focus was to determine if a common enterprise was present. But the opinion in *Carman* recited both the defendant's more general argument that the sales in question did not "satisfy the test set out in *Howey*" as well as his more particular argument that the sales did not satisfy the definition of a common enterprise. *Id.* at 563. And the court expressly considered and rejected an argument virtually identical to the one that the court of appeals accepted here—"that the profits expected by investors were in no way dependent upon the efforts of [the promoter] because the return was in the form of fixed interest, guaranteed by the federal government." *Ibid.* *Carman* cannot be reconciled with the decision in this case.

Respondent seeks (Br. in Opp. 18-19) to distinguish *SEC* v. *Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), cert. denied, 532 U.S. 905 (2001), on the same ground—that it decided only a common enterprise issue and not the question here. That is incorrect. The court expressly addressed and rejected "[t]he defendants' claim that the property transfer

contracts do not constitute 'investment contracts' because the investors were to receive a fixed rate of return rather than a rate dependent on the success of the investments." *Id.* at 189. In doing so, the court cited *Forman*'s description of "profits" under the *Howey* test; and it then held, in the next sentence, that "[t]he mere fact that the expected rate of return is not speculative" did not remove the contracts at issue from the category of investment contracts. *Ibid.* In any event, regardless of what aspect of the *Howey* test the *Infinity Group* court was addressing, it rejected the same argument that the court of appeals accepted here, and the two cases cannot be reconciled.[4]

Respondent also argues (Br. in Opp. 20) that the decision below is consistent with a few court of appeals decisions holding that commercial arrangements, such as loan participation agreements, are not investment contracts. Even if respondent were correct, that would only deepen the circuit conflict and strengthen the argument for review by this Court. The commercial loan cases are, however, distinguishable because they involve transactions of a primarily commercial, rather than investment, character.

3. This Court's review is also warranted because the decision below conflicts with the SEC's longstanding interpretation of the securities laws and will significantly impair its ability to protect investors. See Pet. 23-26.

Contrary to respondent's contention (Br. in Opp. 22-23), the adjudicatory decisions cited in the petition embody the SEC's view that investment contracts can have fixed or contractually guaranteed returns, and those decisions are entitled to deference under *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). Respondent quotes only a few phrases from the decision in *In re Abbett, Sommer & Co.*, 44 S.E.C. 104 (1969), order aff'd, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) 92,813 (D.C. Cir. Sept. 25, 1970), but other portions of the decision quoted in the petition (at 23) make clear that the SEC there determined that a "guarantee[d]," fixed rate of return constituted the "return of profit," and that the investment at issue, which offered that fixed return, was an investment contract. *Id.* at 107-109. And contrary to respondent's contention (Br. in Opp. 23), *In re Union Home Loans*, 26 S.E.C. Dkt. 1517 (Dec. 16, 1982), was not just a report of an investigation but was also an order of the SEC instituting and resolving administrative proceedings under Section 15(b)(4) of the Securities Exchange Act of 1934, 15 U.S.C. 78*o*(b)(4). The fact that the subject of the order did not contest the charges did not render the proceeding something other an adjudication entitled to *Chevron* deference. See *United States* v. *Mead Corp.*, 533 U.S. 218, 226-227 (2001) (deference is due an agency position in an "adjudication" because it is "promulgated in the exercise" of "delegated authority * * * to make rules carrying the force of law").

Although respondent asserts (Br. in Opp. 22) that the SEC's position on the question presented has not been consistent, he does not identify a single instance in which the SEC has expressed a contrary view. Respondent notes that the SEC did not appeal an adverse district court decision in 1978. *Ibid.* (citing *SEC* v. *Energy Group of Am., Inc.*, 459 F. Supp. 1234 (S.D.N.Y. 1978)). But the determination not to appeal that decision—which did not even involve the question presented here—neither reflects acquiescence in its correctness nor binds the SEC in this litigation. See *United States* v. *Mendoza*, 464 U.S. 154, 161-162 (1984). Nor does the SEC's failure to take action against respondent when it first investigated him in 1995 (see Br. in Opp. 22) preclude the SEC from taking action now. See *Utah Power & Light*

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[4] Respondent also attempts to distinguish *Infinity Group* by arguing that there, "even though fixed in percentage," the return "derived from a participation in the earnings of the trust." Br. in Opp. 18. But the investors here expected that their return would derive from ETS's earnings just as much as the investors in *Infinity Group* expected their return to derive from the trust's earnings. See p. 6, *supra*; Exh. 15, at 8 (ETS program offers "special opportunity for individuals to own payphones and earn profits from payphones").

Co. v. *United States*, 243 U.S. 389, 409 (1917); *Graham* v. *SEC*, 222 F.3d 994, 1008 & n.26 (D.C. Cir. 2000).

Finally, contrary to respondent's contention (Br. in Opp. 21), the rule adopted by the court of appeals would create a serious gap in the SEC's enforcement abilities. As the petition notes (at 25), the SEC brought more than two dozen actions involving investment contracts promising fixed or guaranteed returns in fiscal year 2002 alone. The SEC would be precluded from bringing such enforcement actions under the rule adopted by the court of appeals.[5]

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For the reasons stated above and in the petition for a writ of certiorari, the petition should be granted.

Respectfully submitted.

THEODORE B. OLSON
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MARCH 2003

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[5] The SEC's complaint in *SEC* v. *Zanello*, C.A. No. 02-CV-3308 (N.D. Ga. Dec. 10, 2002), does not show otherwise. That filing shows only that the SEC has decided not to forgo enforcement actions involving investment contracts offering fixed returns in the Eleventh Circuit while it seeks this Court's reversal of the erroneous decision in this case. Moreover, if respondent is correct that *Zanello* is on all fours with this case and the interests there are securities even though they are not investment contracts, then there can be no question that the court of appeals erred in this case, because it dismissed the SEC's complaint without remanding for a determination whether the SEC could proceed under another theory. See Pet. 20 n.7.